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Our ref dlG/181

5 October 2012

Dear Mr Gadhia

Audit Market Investigation
KPMG Response to “Liability, Insurance and Settlements” Working Paper

Thank you for affording us the opportunity to comment on the Competition Commission’s (CC’s) “Liability, Insurance and Settlements” Working Paper (the “WP”) published on 14 September 2012.

The overarching conclusion reached by the CC in paragraph 53 of the WP is as follows:

"It appears that the low level of claims settled by firms in the last ten years and the low value of these claims (relative to the size of the firms), combined with the ability of the firms to enter into effective insurance arrangements, suggests that the risks faced by audit firms in relation to professional negligence may be regarded as low."

Whilst we are not privy to the historical data regarding audit negligence claims collected by the Competition Commission from other Big 4 and Mid Tier audit firms, we would not agree with this conclusion based upon our own observations of the market.

In fact, we regard audit as the riskiest part of our business due principally to the inability in practice to limit our liability. Over the last 20-30 years, the number of significant asserted and successful claims and the level of insurance premiums attributable to our Audit function reflects this. It follows, therefore, that the threat of professional negligence claims in relation to statutory audit services is taken very seriously by KPMG (and we would assume by other audit firms).

The relative low level of claims in the UK during the last ten years is not inconsistent with the threat of these claims being strong. It is rather, in our view, to a significant extent a function of the enhanced quality assurance measures the largest audit firms have put in place to minimize the risk that these grounds for claims do not occur. These measures include the client acceptance, audit risk assessment and engagement review processes which help to ensure the

quality of an individual audit, but also the non-engagement specific investments in training, methodology and quality assurance processes.

However, notwithstanding these investments by which we seek to minimize audit risk, it is not practicable to eliminate it. Past claims have in the main been caused by human failure. In particular, we would note that many high profile alleged audit “failures” are linked to senior level fraud within the audit client – which can be notoriously hard to detect, particularly when collusion is involved to conceal it. We believe it is unrealistic to assume that this type of fraud will be eliminated completely and that, notwithstanding the best intentions and efforts of audit firms, when it does occur the audit will not always detect it.

Whilst therefore the frequency of large audit claims has always been low and may have been further reduced in recent years, when they do occur they will often have high impact, and can be very costly given the limitations of insurance.

Given the cycles which are generally considered to apply to professional negligence litigation together with the underlying events which can give rise to it, we do not therefore consider that data pertaining to a ten year time frame and just a single jurisdiction represents an adequate basis for informing a statement about this complex topic. A simple high level resume, on a global level, of the incidence of major professional negligence claims and other related issues faced by the Big 4 over, say, the last twenty years would appear to point towards a conclusion which is more in line with our experience that these are low frequency high impact events.

The 1990s and 2000s provide some very persuasive examples of the potentially destructive effect which professional negligence litigation can have on audit firms. This period saw the disintegration and collapse of one of the largest global audit networks (Andersen) following a major audit failure (Enron). Although Enron, the alleged destruction of work papers and the related actions of the US Department of Justice are regarded as being the single cause of the demise of the Andersen global network, at around the same time Andersen was facing US mega-claims in relation to WorldCom and Global Crossing which added to the financial strain and reputational damage. [§]

Outside KPMG, there have been very serious repercussions on PwC's practices in India and Japan arising from the alleged failure of audits to detect fraud (Satyam and Kanebo respectively). In the same period there have also been a very large number of US mega-claims against all / most of the Big 4, many of which have resulted in settlements above the ceiling of the applicable professional indemnity insurance cover.

Within the UK over the same period, audit firms have settled a number of very substantial negligence claims which had the potential to exceed the limit of available professional indemnity insurance cover and cause potentially fatal financial damage to the firms concerned (KPMG - Independent Insurance; EY - Equitable Life; PwC/EY – BCCI; Deloitte – Barings; PwC – Maxwell; etc).



In addition to the financial impact there is also the risk of reputational damage. As we noted at the recent hearing this would most probably be caused either by a number of audit failures (pointing to systemic failings) or a deliberate act that involved senior personnel at the firm which undermined the firm's reputation for integrity. These are arguably more controllable and hence less likely, but only through continued significant investment in resource-intensive quality control systems, high quality training and the recruitment of talented individuals. Even this risk however cannot be totally eliminated as the experiences of PricewaterhouseCoopers in India and Japan demonstrates.

Finally over the last ten years audit firms have been subjected to increasingly tough and intrusive regulatory control. This has manifested itself in the shape of the AIU (annual regulatory inspection) and the AADB (disciplinary investigation and sanction). One of the consequences of this is that, in cases where an audit failure or other instance of professional negligence does not give rise to civil litigation, there remains an alternative avenue for significant risk – in this case both financial sanctions (the severity of which are currently the subject of a consultation process by the FRC) and reputational damage caused by continuing adverse comments in AIU reports.

Please let me know if you have any questions in relation to the above responses.

Yours sincerely

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Director of Public Policy